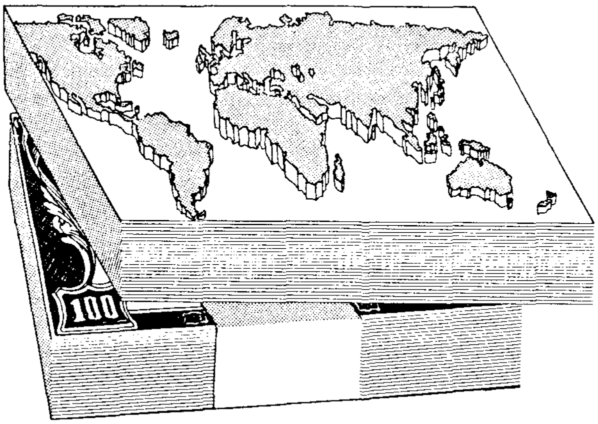
Love, Jim and Ashcroft, Brian and Brooks, Richard and Draper, Paul and Dunlop, Stewart and Leif, Kevin and Lockyer, Cliff and Malloy, Eleanor and McFarland, Mark and McGregor, Peter and McNicoll, Iain and McRory, Eric and Perman, Roger and Stevens, Jim and Swales, Kim and Yin, Ya Ping and , Fraser of Allander Institute (1992) The world economy [March 1992]. Quarterly Economic Commentary, 17 (3). pp. 3-5. ISSN 0306-7866 ,

THE WORLD ECONOMY



MACROECONOMIC TRENDS

GDP growth in the major industrialised countries showed a slight further decline in the third quarter of 1991. Comparing the third quarter with the corresponding period in the previous year, average growth in the G7 countries was 0.5%. This compares with 1.1% for the year to the first quarter of 1991 and 2.3% for the calendar year 1990. As with the previous quarter, German GDP showed a sharp fall, falling below 2% for the year to September. Individual country growth rates were as follows (Q3 1991 on Q3 1990): Canada -0.8%; US -0.9%; Japan 4.2%; France 1.4%; Germany 1.9%; Italy 0.9%; UK -2.2%.

Industrial production did, however, show some recovery in the second half of the year. In the year to November G7 industrial production grew by 0.3%, compared with a decline of a similar amount in the year to July. The growth in the OECD as a whole was 0.4% in the year to November. Interestingly, the former powerhouses of the G7, Germany and Japan, are the countries in which industrial production has slowed down most notably in the second half of the year, with other countries showing an improvement. Individual countries performed as follows (year to November): Canada 0.1%; US 0.6% (December); Japan -1.0% (December); France 1.3%; Germany -1.3% (December); Italy 4.1%; UK -0.6%.

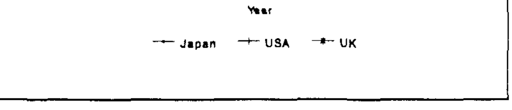
Consumer price inflation has reduced for the third successive quarter. The average annual rate in December was 5.6% for the OECD and 3.4% for the G7 countries (down from 5.9% and 4.0% respectively). Only Italy, UK and Germany now have consumer inflation rates above the G7 average. The G7 countries performed as follows in the year to December: Canada 3.8%; US 3.1%; Japan 2.7%; France 3.1%; Germany 4.2%; Italy 6.0%; UK 4.5%.

There has been very little change in the standardised unemployment rates of the major industrialised countries over the last six months. In November the G7 average was unchanged from its August level of 6.5% As in the last quarter the only substantial rise occurred in the UK where the rate of unemployment rose from 10.0% in August to 10.4% in December. Standardised unemployment rates in the other G7 countries in December were as follows: Canada 10.3%; US 7.0%; Japan 2.1% (November); France 9.8%; Germany 4.5% (November); Italy 9.9% (October).

United States

It is now clear that the recession in the United States economy is not going to go away without a fight. In 1991 as a whole the level of retail sales fell by 0.7% in **nominal** terms, and together with falling industrial output this resulted in a decline in GDP for the year of 0.7%, the first annual decline since 1982. Having seen one apparent recovery peter out in the third quarter of last year, commentators are much more cautious now about forecasting when and by how much the economy will revive in 1992.

Indices of industrial production
Seasonally adjusted (1985=100)



Despite a decline of 0.3% in the leading economic indicators in December and a fall in durable goods orders of 5% in the same month, the White House takes the view that the US economy will grow by 2.2% this year, with growth becoming apparent from the second quarter onwards. This is in line with the Federal Reserve's forecast of 1.75-2.5% growth. Some encouragement has been taken from a final quarter rise in GNP of 0.8%. However, the administration still has a difficult course to steer in encouraging growth without building up inflationary problems. Alan Greenspan, Chairman of the

Federal Reserve, has made it clear that he believes the one percentage point cut in the discount rate before Christmas was quite sufficient to stimulate the economy without resorting to a quick fix in the budget. The discount rate now stands at 3.5%, its lowest level for twenty-seven years.

The problem lies in the budget deficit, which is forecast by the Congressional Budget Office to rise to $352 billion in 1992, 6% of GNP. Others believe the deficit could be as high as $400 billion. This greatly constrains the President's wish to stimulate the economy by fiscal means, and his budget plans were ultimately restricted to relatively minor short-term measures. These included a temporary tax credit for first-time home buyers of up to $5000, a temporary 15% investment tax allowance (not available on property), an increase of $500 in the personal exemption for each child under 18, and a cut in the maximum tax on capital gains from 28% to as little as 15.4% for some assets. The aim, of course is to provide a short-term boost to the economy without causing any more problems for the budget deficit and hence inflation, which fell to 3.1% in 1991, the lowest level for five years.

Since the announcement of the federal budget plans, Alan Greenspan has been 'talking up' the economy, predicting a fairly rapid recovery in the second quarter of this year as a result of increased consumer spending and improved industrial output as businesses seek to replenish their inventories which have decline substantially during the last year. Recent economic data have provided at best a mixed response to his upbeat statements. Provisional retail sales figures for January indicated a rise of 0.6% during the month, with the figures for November and December revised upwards to zero from provisional estimates of substantial declines. In addition, housing starts have recovered to some extent, rising by 5.5% in January to level 38% higher than the corresponding month in 1991, which was adversely affected by concerns over the Gulf war. However, more recent data suggest that the problems are not yet over. Manufacturing output continues to decline, and more worryingly consumer confidence fell in both January and February to its lowest level since 1974. At best, recovery still seems uncertain.

Japan

The last Commentary indicated that the principal economic concerns facing Japan were a slowing economy and a growing trade surplus. These issues continue to dominate economic thinking. The period until the middle of last year was the longest unbroken run of economic expansion experienced by Japan since the second world war, and latterly was based in part on an unsustainable economic 'bubble' of rising prices on investment assets, including land. The economic planning agency now considers the present phase of economic activity to be one of 'correction', the first time this has happened in over fifteen years.

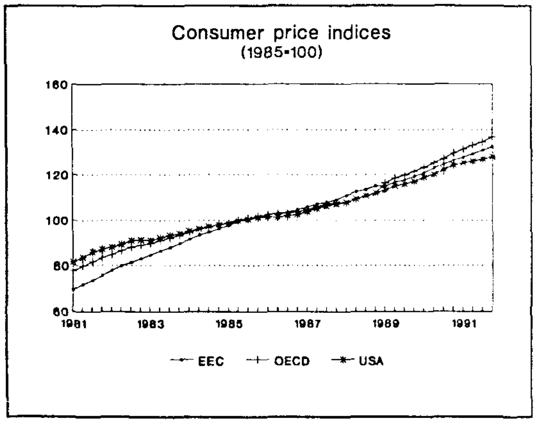
Industrial output in 1991 grew at 2.1%, the slowest rate of growth for five years, and is continuing to decline quite rapidly. For example, revised figures indicate that industrial production in December was almost 2% below its level of a year earlier. There is some evidence that industry is finding the adjustment to a rapidly slowing economy rather difficult - probably because businessmen have had so little practice in this department. Inventories are continuing to rise, and in December were 13.1% higher than the corresponding month in 1990, indicating that further declines in industrial output are likely. As a result of the slowdown it is now forecast that manufacturing investment may fall by as much as 11% during the fiscal year 1992-93, which would represent the first decline in six years.

However, while the Japanese economy may not give such a large boost to G7 growth in the next year as has been the norm in the recent past, there are still few signs of a recession of US or UK proportions. At the end of December the official discount rate was lowered for the third time in less than a year, and now stands at 4.5%. Should it prove necessary, there is plenty of room for further relaxation of monetary policy. The OECD now forecasts GNP growth of 2.4% in 1992, largely in line with most private forecasters. This is slow by recent Japanese standards, but light years removed from a real recession. The 'correction' referred to earlier is also having the effect of squeezing out the inflationary pressure introduced by the rapid rises in many investment assets, with consumer price inflation forecast by the OECD to fall to 2.0% this year.

But even if a Japanese version of a soft landing is achieved, the fly in the ointment remains the rising trade surplus. Last November the current account surplus was $7.3 billion, higher by a factor of four than the figure for the corresponding month in 1990. For 1991 as a whole the trade surplus rose to $78.2 billion, half as high again as 1990, and the first annual rise for four years. Exports rose by 9.6% while imports rose by only 0.7%. The surplus with the US rose slightly (by 1.4%), while that with the EC rose by 48%. While the Bank of Japan takes the view that most of the rise is due to special factors such as currency fluctuations and lower oil prices, it nevertheless seems possible that relationships between Japan and much of the West could become distinctly strained over the trade issue, especially as the US and the EC countries struggle with persistently sluggish domestic economies.

Germany

The German monetary authorities have reacted to the prospect of 4% inflation with their customary zeal, raising the discount rate half a point in December to 8% - the highest level of interest rates since 1931. In the final quarter of 1991 M3, the targeted measure of broad money, rose at an annual rate of 9.5%, which the Bundesbank sees as clear justification for its interest rate rise. In addition, the bank has issued a series of stern warnings that the 6.35% pay increase awarded to steel workers should not be regarded as the going rate in 1992, with pay settlements of under 6% being acceptable. Unit wage costs in the final quarter of 1991 were 7.5% higher than the corresponding period in 1990, a situation which the Bundesbank does not care for.



Meanwhile the German economy slows down into recession or cyclical adjustment, depending on your point of view. There is agreement that west German GNP fell by 0.5% during the final quarter of last year, the third successive quarterly decline. While for most economists this would fulfil the technical definition of a recession, the Ifo economics institute in Munich prefers to see it simply as a cyclical weakening which appears worse than it actually is because of the need for adjustment from the rapid growth of 1990-91. Ifo sees no sign of a real recession, and believes that the economy will recover from the middle of this year, as long as most of the other industrialised countries do not remain in deep recession and domestic consumer expenditure picks up.

Others are not quite so sanguine. The economics ministry has indicated that the economy is at a 'watershed', and picking up the theme of the Bundesbank, has indicated that one of two factors which could tip the balance into a lengthy recession is continuing high wage settlements. The other is the failure of the Gatt negotiations. The pace of change in the German economy is illustrated by the rapid deterioration in the country's trade surplus. The visible trade surplus fell from DM107.4 billion in 1990 to DM20.8 billion in 1991, while the overall balance of payments changed from a surplus of DM77.4 billion in 1990 to a deficit of DM34.2 billion in 1991 (this includes Gulf war payments). This resulted from an import surge to fuel demand in the east last year combined with declining world demand for German exports, exactly the reverse of the situation which is currently happening in Japan.

And then there is the east. The DIW economics institute in Berlin now estimates that east German GNP fell 30% last year, not 20% as previously thought, mainly as a result of an overestimate of construction output. While there is now some sign of an upturn in the east of the country, the Treuhand is still grappling with the problem of channelling its funds towards the reconstruction of companies and whole industries, rather than simply providing them with working capital. The costs of this operation continue to be borne mainly by the west, and this cost may begin to be seen as less and less acceptable as growth in the west continues to slow.

PROGNOSIS

Although still somewhat out of synchronisation, the economies of most of the industrialised countries are now either firmly in the downward part of the cycle or just beginning to show signs of turning up once again. The key issue for the G7 group is how deep and lengthy is the slowdown in both Germany and Japan. If reasonably short and shallow in both, then the major industrialised countries can expect a recovery before the end of 1992. However, it is necessary to stress once again the importance of a successful conclusion to the Gatt negotiations, especially as trade issues seem likely to become of central importance again with the rapid rise in the Japanese trade surplus.